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MANUFACTURERS HANOVER

Economic Report

January 1988

Commentary on Pertinent Economic Issues

Economic Forecast For 1988*

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The new year finds the business outlook murkier than ever. There is widespread disagreement among economists over where we are today–not to mention regarding where we are heading over the balance of 1988. The range of expectations hasn't been this wide since the end of 1982. Interestingly, the United States economy reached a major turning point at that time (the end of the 1981-82 recession), and it may well be at another critical juncture (the onset of a new recession) today.

One aspect of the business outlook seems to unite the forecasters. This is the feeling that economic growth will slow significantly during 1988–especially in the first half of the year. Some think business will pick up again by the summer, while others feel the economy will be sluggish all year. In my opinion, it would be prudent to expect a recession this year–not a bad one, but clearly a change from the growth environment of the past five years.

Recession Is At Hand

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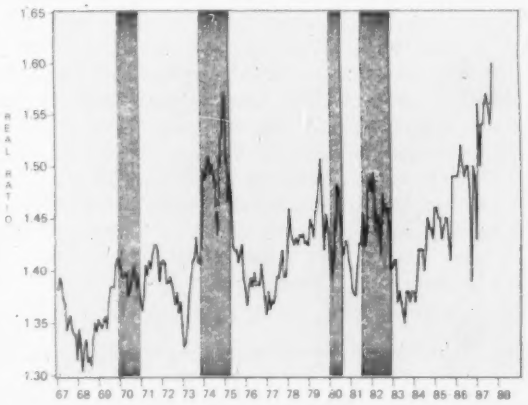
As many may already be aware, my forecast of a recession in 1988 is not a recently adopted position. It predates not only the stock market's plunge of last October–but even the slide that began two months earlier, in late August 1987. Indeed, it goes back to last spring. At that time, we saw a number of signs that in the past have signaled the onset of recession:

- The ongoing expansion had become twice as long as the average peacetime upswing, meaning that it was becoming increasingly susceptible to being derailed;
- Fiscal policy was tightening sharply, since the government's budget deficit was in the process of contracting by one-third;
- Monetary policy had turned restrictive, whether one looked at the money supply, which stopped growing in the spring, or at short-term interest rates, which had actually bottomed out in early October 1986;
- Long-term rates began shooting up in April 1987, as bond buyers became aware that inflation had returned;

CHART I
RETAIL TRADE REAL INVENTORY–SALES RATIO



- The rise in the rate of inflation was not matched by an equivalent increase in wages and salaries, leading to a drop in people's buying power;
- The combination of reduced buying power and less borrowing power, along with the generally high level of debt and low rate of savings caused consumers to reduce their purchases of autos and housing–two mainstays of our economy;
- Consumer spending in general began to falter, although it was offset for a while by stepped-up production for exports in the wake of the lower-valued dollar.

Because of this last factor, as well as because the stock market had not as yet reached a peak, we believed that the U.S. could avoid a recession in 1987. This appears to have been the case–at least according to preliminary data covering last year's gross national product. However, a closer examination of these statistics, as well as an assessment of the developments that have taken place in the stock market since the August peak suggests that the five-year expansion has just about run out of string.

*Based on testimony given before the U.S. Congress, Joint Economic Committee, hearing on the economic outlook and policy options for 1988, January 22, 1988.

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The signal sent by the stock market's decline should not be ignored. For one thing, while not every decline in stock prices has led to a recession, every recession in the past half century has been preceded by a drop in the stock market. What is more, the only time in this century when a plunge in stock prices the size of the decline between August 25 and October 19, 36 percent, was *not* followed by a recession was during World War II, when the military buildup kept the economy rising even though the market had fallen by over 40 percent.

Consumers Are Retrenching

Since we are not on a wartime footing today, it seems reasonable to expect the negative impact of the market's fall to spread throughout the economy. Those who own stocks are clearly less wealthy today than they were last August, while they, and the vast majority of people in the U.S. who don't own stocks, are surely less confident. The record shows that these developments lead to reduced outlays–which can be seen from the statistics describing consumer spending. Nominal retail sales were about two percent lower in December 1987 than they were back in September 1986, while "real" sales, after adjusting for inflation, were down by more than twice that much. Taking the volatile auto sector out of the picture finds real retail sales down by two percent in the last ten months alone.

On the other hand, production of goods destined for final consumers has actually sped up since summer 1986. While real retail sales have been falling, output has climbed by five percent. Not surprisingly, inventories are beginning to pile up. The Commerce Department's latest tabulation shows a sharp two percent increase in total business inventories in the past two months. And since total business sales have actually fallen during this time, the important ratio of inventories to sales has begun to rise.

As is usually the case, the backup of unsold goods is most prominent at the retail level. Not only has the ratio of inventories to sales adjusted for inflation been climbing sharply since autumn 1986, but it is higher now than at anytime in the past 20 years–a period spanning four recessions (Chart I)! Merchants must now be in the process of putting on the brakes, because in the past few months, wholesalers' inventories have begun to shoot up, causing their I-S ratios to rise from the 13-year low reached this past summer.

At the manufacturing level, inventories have been rising for about a year, but since sales have gone up even faster, producers' I-S ratios are still falling. However, once wholesalers decide that their stockpiles are too high and begin to reduce their orders, factory sales will lose some of their zip. This will leave producers in particular–and the economy in general–dependent on capital goods and exports for continued growth.

It may not be enough. For one thing, these two sectors combined amount to less than one-quarter of the gross national product. This means that output of capital goods as well as goods destined for export would have to grow even faster than in 1987 to offset the on-going weakness in consumer spending, which accounts for two-thirds of the GNP.

There is no disputing the fact that production of these goods is in a sharp rise. Output of business equipment jumped six percent in 1987, responding to a surge of similar magnitude in business spending for capital goods. And a recent government survey of business spending plans suggests that an even greater rise might be in store for 1988. However, this increase might not come to pass, since most of it represents spending on equipment, which can easily be postponed or even cancelled, should economic conditions warrant it.

January, 1988
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1987				YEAR 1987		1988				YEAR 1988	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	4377.7	4445.1	4524.0	4598.0	4486.4	5.9	4610.7	4637.4	4674.4	4722.3	4661.3	3.9
GNP: $82	3772.2	3795.3	3835.9	3875.1	3819.6	2.9	3841.8	3820.0	3809.3	3802.4	3818.4	0.0
% Change, Annual Rates	4.4	2.5	4.3	4.2	2.9		−3.4	−2.3	−1.1	−0.7	0.0	
Consumption $82	2475.9	2487.5	2520.7	2496.6	2495.2	1.8	2501.2	2505.7	2501.8	2492.8	2500.4	0.2
Durables $82	375.9	385.4	406.9	384.4	388.1	1.2	384.4	383.8	380.0	376.0	381.0	−1.8
Non-Durables $82	883.2	879.0	875.7	865.6	875.9	−0.2	864.6	863.1	860.6	854.2	860.6	−1.7
Services $82	1216.9	1223.1	1238.1	1246.6	1231.2	3.5	1252.2	1258.8	1261.2	1262.7	1258.7	2.2
Investment $82	671.8	673.7	681.9	714.2	685.4	4.8	679.5	657.2	638.5	624.8	650.0	−5.2
Non-Residential $82	426.0	437.9	463.8	459.6	446.8	0.7	455.4	453.6	446.6	439.3	448.7	0.4
Producers Durable Equip. $82	305.6	317.5	336.6	330.4	322.5	2.9	327.3	326.6	320.7	316.4	322.7	0.1
Structures $82	120.4	120.4	127.2	129.2	124.3	−4.6	128.1	127.0	125.9	122.9	126.0	1.4
Residential $82	198.2	196.8	193.5	196.3	196.2	−0.1	186.2	186.3	185.7	187.4	186.4	−5.0
Inventory Changes $82	47.6	39.0	24.6	58.3	42.4		38.0	17.3	6.2	−1.9	14.9	
Net Exports $82	−135.2	−132.7	−138.5	−130.7	−134.3		−121 9	−115.2	−108.7	−103.8	−112.4	
Government Purchases $82	759.6	766.7	771.6	795.0	773.2	2.5	783.0	772.3	777.7	788.6	780.4	0.9
Federal Defense $82	257.4	263.5	268.3	267.8	264.2	5.4	262.0	256.2	253.5	254.3	256.5	−2.9
Federal Civilian $82	69.9	69.1	67.9	86.7	73.4	−10.2	75.3	68.3	74.3	82.1	75.0	2.2
State & Local $82	432.3	434.1	435.4	440.5	435.6	3.2	445.7	447.8	449.9	452.2	448.9	3.1
Final Sales: $82	3724.6	3756.3	3811.3	3816.8	3777.2	2.1	3803.8	3802.7	3803.1	3804.3	3803.5	0.7
% Change, Annual Rates	−2.3	3.4	6.0	0.6	2.1		−1.4	−0.1	0.0	0.1	0.7	
Domestic Demand: $82	3907.4	3928.0	3974.4	4005.8	3953.9	2.5	3963.7	3935.2	3918.0	3906.2	3930.8	−0.6
% Change, Annual Rates	2.5	2.1	4.8	3.2	2.5		−4.1	−2.8	−1.7	−1.2	−0.6	
GNP Price Index (1982 = 100)	116.1	117.1	117.9	118.7	117.4	3.0	120.0	121.4	122.7	124.2	122.1	3.9
% Change, Annual Rates	4.2	3.5	2.8	2.7	3.0		4.5	4.7	4.4	4.9	3.9	
Consumer Price Index (1967 = 100)	335.0	339.0	342.3	345.3	340.4	3.7	349.1	352.5	355.6	358.2	353.8	4.0
% Change, Annual Rates	5.3	4.9	3.9	3.6	3.7		4.5	4.0	3.6	3.0	4.0	
Total Personal Income	3662.0	3708.6	3761.0	3851.5	3745.8	6.0	3856.6	3890.0	3941.5	3995.4	3920.9	4.7
Disposable Personal Income	3125.9	3130.6	3195.3	3272.6	3181.1	5.3	3298.8	3327.1	3372.9	3418.4	3354.3	5.4
Savings Rate	4.4	3.0	2.8	4.9	3.8		4.3	3.9	4.3	4.7	4.3	
Unemployment Rate	6.7	6.2	6.0	5.9	6.2		6.0	6.4	6.8	7.2	6.6	
Indus. Production (1977 = 100)	126.9	128.2	130.9	133.0	129.8	3.7	130.1	125.7	123.0	120.1	124.7	−3.9
Housing Starts (000)	1794.7	1611.7	1623.0	1516.7	1636.5	−10.0	1515.1	1487.5	1475.3	1500.3	1494.5	−8.7
Dom. Auto & Lt. Truck Sales (000)	10208.0	11285.0	11937.7	10393.7	10956.1	−7.7	9906.0	9815.1	9506.3	9022.2	9562.4	−12.7
Corporate Pre-Tax Profits	257.0	268.7	284.9	274.6*	271.3	17.0	251.8	246.9	239.2	247.7	246.4	−9.2
− Taxes	128.0	134.2	143.0	141.1	136.6		118.3	114.8	110.0	111.9	113.8	
Net Profits	129.0	134.5	141.9	133.5	134.7	6.2	133.5	132.1	129.1	135.7	132.6	−1.6
− Dividend Payments	90.3	92.4	95.2	95.2	93.3	7.5	98.9	100.4	101.5	102.4	100.8	8.1
Undistributed Profits	38.7	42.1	46.7	38.3	41.4	3.5	34.6	31.7	27.6	33.3	31.8	−23.2
+ Depreciation	340.0	342.5	345.5	347.7	343.9		352.0	355.4	357.6	358.5	355.9	
− Inventory Profits	11.3	20.0	17.6	8.0	14.2		8.6	8.8	8.5	8.4	8.6	
Net Cash Flow	367.4	364.6	374.6	378.0	371.1	−1.1	378.0	378.3	376.7	383.4	379.1	2.1

*Forecast

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Exports Can't Help Much

Most of the hopes for avoiding a recession are therefore being pinned on exports. After rising only slightly in 1986, exports in the first 11 months of 1987 shot up 15 percent. But to offset just a flattening in consumer spending–which is nearly six times as large–exports would have to rise about one-third faster this year than in 1987. Notwithstanding the fact that the dollar is worth only about half as much today as it was three years ago when compared with the major industrial currencies, it won't be easy for goods producers to achieve this objective.

For one thing, U.S. industry has already shifted a lot of its productive capacity overseas, responding to the earlier strength in the dollar, as well as lower labor and other costs. Whatever comes out of these offshore facilities will not benefit the U.S. economy. For another, while average domestic operating rates remain only around 82 percent, well below peaks reached in earlier cycles, capacity utilization in a number of industries–especially those involved in exporting–are much higher. The paper materials industry, as an example, is operating at 99 percent of capacity, a near record, while other parts of this industry are operating at rates in the mid-90s. Textile mills are running at better than 94 percent of capacity, while the iron and steel industry is at 91 percent. Aerospace, chemical materials, rubber and plastics are all at 88 percent.

Besides putting a lid on export growth, these high rates of capacity use have led to significant price pressures. Industrial raw materials have climbed nearly 40 percent from their August 1986 lows. At the producer, or wholesale, level, this surge has translated into an accelerating rise in prices of intermediate goods, excluding food and energy. Last quarter, for the sixth quarter in a row, this index rose at a faster pace than it did in the preceding quarter (Chart II).

With prices of imported goods up at least 10 percent over the past year, the only thing that has prevented these pressures from spilling over into the consumer price index (which still rose four times faster in 1987 than it did in 1986) is the softness in consumer demand. If the economy manages to avoid a recession this year, these bottled-up inflation pressures would seem likely to surface.

Another byproduct of continued economic growth this year would be a renewed decline in the dollar. This is because, instead of shrinking as might be expected in a recession year, imports will remain high, owing to the expansion in buying power that would accompany continued economic growth. The resulting lack of progress in bringing down the trade deficit is what could pressure the dollar. Needless to say, a lower dollar, combined with more inflation, would boost interest rates and send the stock market tumbling once again. The net result: an even worse recession in 1989.

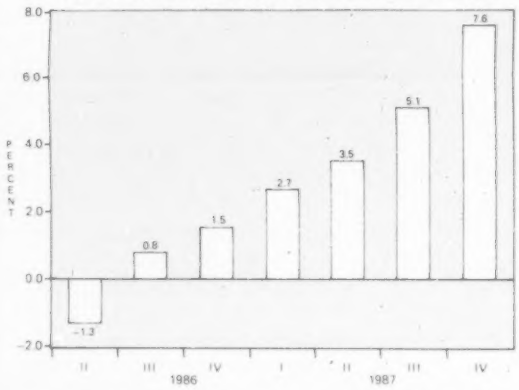
On the other hand, a recession in 1988 would not be without a silver lining. To be sure, there are people who will lose their jobs in a recession, while many businesses will sustain reduced sales and earnings. For these folks, the "benefits" of recession are, understandably, small consolation. Nonetheless, there are some pluses to be aware of, one of which will be a continued bottling up of inflation, since neither business nor labor will be able to raise prices and wages very much when the economy is soft.

As it becomes evident that inflation pressures are being vented, the financial markets will become less tense, and interest rates should begin to fall. This decline

(Continued)

should be aided by an easing of Federal Reserve monetary policy, as usually happens once a recession is underway and inflation is perceived as less of a threat. These lower rates need not push the dollar down, since our foreign trade deficit would be improving. Thirty percent of the goods we consume is imported, so it stands to reason that declining demand will result in fewer imports as well.

CHART II
PRODUCER PRICE INDEX – INTERMEDIATE GOODS
EXCLUDING FOOD AND ENERGY
(QUARTERLY PERCENT CHANGE AT AN ANNUAL RATE)



As the dollar stabilizes, foreign funds will return to the U.S. Declining interest rates should encourage both foreign and domestic funds to flow into the stock market. Once the stock market gets out of its rut and begins to rise on a sustained basis, wealth and confidence will return, laying the groundwork for a new economic recovery.

No Policy Options

One final point. Because this is a presidential election year, you might be wondering what, if anything the Administration might be able to do to delay the onset of this recession, since the record shows that bad times in years divisible by four tend to lead to a change in the party occupying the White House. The answer, in my opinion, is not very much.

For one thing, we may already be in a recession, in which case it is obviously too late. But even if we are not, there do not seem to be any options open to the Administration at this point. Fiscal policy is virtually powerless. Any efforts to ward off a recession (by either spending increases or tax reductions) would be difficult to implement, because they would involve deliberately increasing Washington's budget deficit at a time when most everyone wants to see the deficit shrink. Monetary policy might be used—but only *after* a recession gets underway. It does not seem likely that the financial markets will tolerate lower interest rates and rapid money growth engineered by a central bank, all of whose members have been appointed by the party in the White House, until business conditions require them.

A third policy tool is foreign exchange. Pushing the dollar lower, thereby making exports cheaper and imports even more expensive, could ward off a recession. However, as the Administration learned several months ago, it could also discourage the inflow of foreign funds needed to finance our current deficits. In turn, this could lead to higher—not lower—interest rates by adding to domestic inflation, and, perhaps, to another plunge in stock prices. ■

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